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In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 609

BOSTON ELEVATED RAILWAY COMPANY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 97–118) is reported at 45 B. T. A. 906. The opinion of the circuit court of appeals (R. 127–133) is reported at 131 F. (2d) 161.

JURISDICTION

The judgment of the circuit court of appeals was entered November 4, 1942 (R. 134). The petition for a writ of certiorari was filed December 31, 1942. The jurisdiction of this Court is

invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The Commonwealth of Massachusetts provided by statute (known as the Public Control Act) for the operation of the Boston Elevated Railway Company by public trustees. The Act guaranteed that, if the Company's earnings should be insufficient to pay its operating costs *plus dividends* at a fixed rate, the Commonwealth would annually pay the difference. In the event that the earnings should exceed the operating costs plus such dividends, the excess was to be placed in a "reserve fund." Ultimately, it was to be paid over to the Commonwealth and in the meanwhile it could be drawn upon to satisfy the Commonwealth's guarantee.

The Company has been operating at a deficit since 1931 and during the years 1933–1937, here involved, the Commonwealth paid an average of about $2,000,000 a year in accord with its guarantee. The question is whether those payments constituted taxable income to the Company.

STATUTES INVOLVED

Revenue Act of 1932, c. 209, 47 Stat. 169:

> SEC. 22. GROSS INCOME.
>
> (a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in

> whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits, and income derived from any source whatever * * *.

The relevant provisions of Massachusetts Special Acts, 1918, c. 159, as amended (known as the Public Control Act) are either quoted or summarized in the Statement, pp. 4–6, *infra*, and are printed in full at pp. 10–28 of the petition.

STATEMENT

The petitioner, the Boston Elevated Railway Company, is a corporation engaged in the transportation of passengers by elevated, subway and surface railway, and by bus lines, in the City of Boston and suburban cities and towns. During the tax years here involved, the properties were operated under public management by a board of trustees appointed by the Governor of the Commonwealth of Massachusetts in accordance with the Public Control Act of May 22, 1918, as amended.[1] (R. 101.) The trustees act-

[1] This Act was considered by the Court in connection with other questions in *Boston* v. *Jackson*, 260 U. S. 309, and *Helvering* v. *Powers*, 293 U. S. 214.

ing as agents of the company and not of the Commonwealth, exercised "all the rights and powers of said company and its directors", including the payment of dividends (Sections 2, 3).

The basic scheme of the Public Control Act is that the company in exchange for its surrender of management and control shall annually receive, after all expenses, a sum adequate to pay dividends on the preferred stock at the specified rates and on the common stock at the rate of five per centum and no more (Section 6, as amended by chapter 333, Section 2, of Acts of 1931). The mechanics for achieving that result are as follows: Section 6 requires the trustees to fix such rates of fare as will reasonably produce sufficient income to meet the "cost of the service", which is expressly defined to include operating expenses, fixed charges, taxes, and the stipulated dividends upon the capital stock. Section 6 also specifically prohibits the payment of dividends in any greater amount. Sections 5 and 9 require that a reserve fund be set aside. It is to be drawn upon when the earnings do not equal the "cost of the service" and into it are paid any annual earnings in excess of the "cost of the service". Section 11 as amended by Special Acts of 1919, c. 244, makes provision for securing to the company the "cost of the service", including dividends, in the event that the reserve fund should be exhausted. To that end it provides:

> If, as of the last day of June in the year nineteen hundred and nineteen, or the last day of any June thereafter,[2] the amount remaining in the reserve fund shall be insufficient to meet the deficiency mentioned in section nine, it shall be the duty of the trustees to notify the treasurer and receiver general of the commonwealth of the amount of such deficiency, less the amount, if any, in the reserve fund applicable thereto, and the commonwealth shall thereupon pay over to the company the amount so ascertained. Pending such payment it shall be the duty of the trustees to borrow such amount of money as may be necessary to enable them to make all payments, including dividend payments, as they become due. If, as of the last day of any June thereafter during the period of public operation, the reserve fund shall exceed the amount originally established, the trustees shall apply the excess, so far as necessary, to reimbursing the commonwealth for any amounts which it may have paid to the company under the provisions hereof * * *.

Section 13 provides that at the end of the term of public management and control, any deficiency in the original amount of the reserve fund shall be made up by the Commonwealth and that any excess over the original amount shall be paid to

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[2] By chapter 99 of Acts of 1935 this date was changed to March for the years subsequent to 1934.

the Commonwealth. Thus, the arrangement secured the company a fixed annual return over expenses and provided that any earnings in excess of that amount should go to the Commonwealth, first, as a reserve to meet the Commonwealth's obligation and, ultimately, as actual payments into its Treasury.

In 1931 the reserve fund was exhausted. In each of the years 1933 to 1937 the earnings were below the stipulated amount, and accordingly the Commonwealth paid to the company sums averaging nearly $2,000,000 each year (R. 107–108). These moneys were credited annually to the company's profit and loss account and were used, after payment of expenses not covered by earnings, to pay annual dividends of $1,193,970 (R. 109).

The company did not include the payments by the Commonwealth in gross income in making up its income tax returns (R. 64). The Commissioner ruled that the payments should have been so included and determined a deficiency. The Board of Tax Appeals sustained the Commissioner's determination upon this point (R. 118)[3] and its decision in turn was affirmed by the circuit court of appeals (R. 134).

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[3] The Board held that certain details of the Commissioner's computations were erroneous and required recomputations (R. 117, 118).

ARGUMENT

In *Texas & Pacific Ry. Co.* v. *United States*, 286 U. S. 285, the Court held to be taxable income payments made to a carrier by the United States under an agreement guaranteeing the carrier a specified operating income for six months in exchange for its promise to pay to the United States any earnings in excess of the agreed amount. The instant case is identical, except that the arrangement extends over a series of annual accounting periods instead of a single six months period. The only contention open to petitioner, therefore, is that the deficiency payments made by the Commonwealth were loans and not income because there might possibly be excess earnings in a subsequent annual accounting period which would go to reimburse the Commonwealth. But the nature of the deficiency payments depends upon the interpretation to be given the Public Control Act and not upon any disputed questions of federal law. The court below was undoubtedly familiar with the local background of the Act and the correctness of its interpretation is not a matter of such general importance as to require decision by this Court.

Moreover, the ruling of the circuit court of appeals is plainly correct. "The Act, accepted by the Company, constitutes in substance an agreement between the Company and the Com-

monwealth that the latter shall temporarily take over the management and operation and pay specified amounts by way of compensation" (*Helvering* v. *Powers*, 293 U. S. 214, 223). The essence of the arrangement was that the company should receive the guaranteed annual compensation from earnings so far as possible and the balance in payments from the Commonwealth if necessary, while on the other hand the Commonwealth should receive the earnings of any year in excess of the guaranteed compensation.

In so analyzing the Public Control Act, we do not overlook the provisions establishing and governing the reserve fund. The Commonwealth meets its obligations under the Act by assessing the cities and towns served by the property for any deficiencies paid by it, and it is required to distribute to them any earnings in excess of the guaranteed compensation (Sections 11, 13, 14). The underlying theory is that the people benefited by the properties should pay the exact cost of service; their contribution in the form of fares is therefore increased in the amount of assessments for payments necessary to make up deficiencies in earnings or decreased by the redistribution of excess earnings. The provisions establishing and governing the reserve fund were intended to avoid, so far as possible, the necessity of making these assessments and distributions an-

nually to meet fluctuations in earnings. To this end the Act provides that the deficiency payments shall be made from the reserve fund whenever possible and that the annual excess earnings should be put into and retained in the reserve fund until the termination of public control, unless the reserve fund should be above its original level and the Commonwealth should require reimbursement for prior deficiency payments. But this is the only purpose of the reserve fund provisions. So far as concerns the relationship between the Commonwealth and the company, it was intended to make the settlement on an annual basis so that the company would annually receive the fixed compensation and no more.

There is no such relationship between the deficiency payments by the Commonwealth and the payments of excess earnings by the company as would warrant treating the former as loans or advances to be repaid from excess earnings. The obligation of the Commonwealth is not conditioned upon the existence of excess earnings from the past or upon the possibility of excess earnings in the future. The company made no promise of repayment, absolute or conditional. Furthermore, the company's obligation is to turn over all earnings in any year in excess of the guaranteed annual income, whether or not deficiency payments have been made by

the Commonwealth which it has not recouped. Over a period of years the payments made by the Commonwealth might be offset by the earnings in excess of the guaranteed minimum but that outcome would be the result of chance; the Public Control Act does not relate the two, and neither the company's nor the Commonwealth's payments are in any sense a return of payments made by the other.

The company's treatment of the payments by the Commonwealth also shows that they were not loans. They were entered in the profit and loss account and were distributed as ordinary dividends. The dividends were, of course, income to the stockholders, but under Section 25 of the Revenue Acts of 1932 and 1934 they were exempted from the normal tax on the theory that they were distributions of corporate earnings or profits. The court below correctly held, therefore, that the annual payments to the company were not loans but were income subject to its unrestricted control, and were subject to be taxed in the year in which they are accrued.[4] *Texas & Pacific Ry. Co.* v. *United States,* 286 U. S. 285; *Helvering* v. *Clai-*

[4] The company keeps its books on the accrual basis of accounting (R. 63).

borne-Annapolis Ferry Co., 93 F. (2d) 875 (C. C. A. 4), and *Lykes Bros. S. S. Co.* v. *Commissioner*, 126 F. (2d) 725 (C. C. A. 5). The possibility that the company may at some future date be called upon to make payments to the Commonwealth—a possibility which is now exceedingly remote—does not exempt from the tax the income which it has received. *North American Oil Consolidated* v. *Burnet*, 286 U. S. 417; *National City Bank of New York v. Helvering*, 98 F. (2d) 93 (C. C. A. 2); *Barker* v. *Magruder*, 95 F. (2d) 122 (App. D. C.)

Petitioner contends that the decision below conflicts with two decisions of the Circuit Court of Appeals for the Fifth Circuit but examination of those cases shows that they are not in point. In *McKnight* v. *Commissioner*, 127 F. (2d) 572, the court held only that the principal amounts embezzled by a taxpayer were not income to him at the time of the embezzlement. In *Clinton Hotel Realty Corp.* v. *Commissioner*, 128 F. (2d) 968, a deposit made under a contract of lease was held not to be income when made because it was to be held by the lessor as security for the performance of the covenants of the lessee and was not subject to the unrestricted control of the lessor. Factually, those situations are too remote to be persuasive here.

CONCLUSION

There is no conflict of decisions or question of general importance. The decision of the circuit court of appeals is correct. The petition for a writ of certiorari should be denied.

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